Tax/compensation schemes:
Misleading advice in a rent-seeking society

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It is always a temptation to an armed and agile nation
To call upon a neighbor and to say: –
'We invaded you last night – we are quite prepared to fight,
Unless you pay us cash to go away'....

It is always a temptation to a rich and lazy nation,
To puff and look important and to say: –
'Though we know we should defeat you, we have not the
time to meet you.
We will therefore pay you cash to go away.'

1. Introduction

Economists have long advocated tax/compensation schemes as a means of achieving general agreement on the elimination of tariffs and other forms of restrictive and efficiency reducing forms of regulation. Conventional microstatics clearly reveal that tariffs and other forms of protective control of markets result in a deadweight loss to the economy. Hence, a policy shift that eliminates market inefficiency will result in benefits to the ‘gainers’ that exceed losses to the ‘losers.’ By taxing the gainers sufficiently to more than compensate the losers for their losses from the policy shift, the protective control of markets can be dissolved, or so it is argued. An appropriately constructed tax and compensation schedule should leave everyone ‘betteroff’ and, thereby, in perfect accord over the policy change. The tax/compensation scheme is, thereby, supported because it is Pareto efficient.

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2. Flaws in the conventional analysis

A common presumption undergirding the tax/compensation proposal is that its adoption would lead to less protection and regulation of the economy—and less inefficiency. Such a conclusion is, however, unwarranted, if the prospects of rent-seeking in an unconstrained political environment are considered. Five critically important, but seriously flawed, assumptions undergird this standard tax/compensation analysis.

First, the analysis presumes that a tax/compensation scheme will install new incentives to rescind protective regulation, which it may do in the narrow context of any given 'buyout.' However, the conventional analysis fails to recognize that a buyout of a protected industry, by definition, amounts to an increase in the expected rewards from protection, or else the protected industry would not give its consent to the buyout. To the extent that rent-seeking activities are effective, a tax/compensation scheme will increase, not decrease, the degree of protection and, consequently, the deadweight loss from protection. This is especially true if the buyout contract does not prevent the protected industry from petitioning government again for protection once it has been bought out. And it is difficult to see how the once-protected industry could be prevented, short of a constitutional prohibition against protective regulation, from seeking re-regulation. Because of the buyout, the bought-out industry will not only have a greater incentive to re-seek protection, since the return on its political investment will have been raised, but it will have greater wealth, i.e., the funds from the buyout, with which to re-seek the rents it once had. Other industries will, of course, attempt to follow the example of the bought-out industry and acquire the protection with the intent of seeking compensation for a buyout. In addition to seeking government protection in order to acquire the added rents, many of these industries will be coaxed into competing for the rents just to protect themselves from being a part of the population that must, on balance, bear the costs of protective regulation. The greater competition for rents should be expected to escalate the rent seeking wastes.

Second, proponents of tax/compensation schemes assume that their proposals should achieve unanimous consent within the community, since everyone is presumed to gain from the policy change. These policy proponents must be left to wonder why such tax/compensation schemes are so rarely taken seriously in the political process. Indeed, tax/compensation schemes are generally dismissed almost without a second thought even by the protected industry (which should by the standards of the cost/benefit calculus on which the proposals are founded gain, on balance, from them). The rent-seeking perspective suggests that in the absence of constitutional constraints that would prevent or contain the amount of rent-seeking induced by the tax/compensation policies (and such constraints are not usually